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NACROCOSM

Shale Survives, and May Soon Thrive

Tuesday, December 8, 2020

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OPEC accommodates US market share, and restarting shut-ins provides needed cash flow.

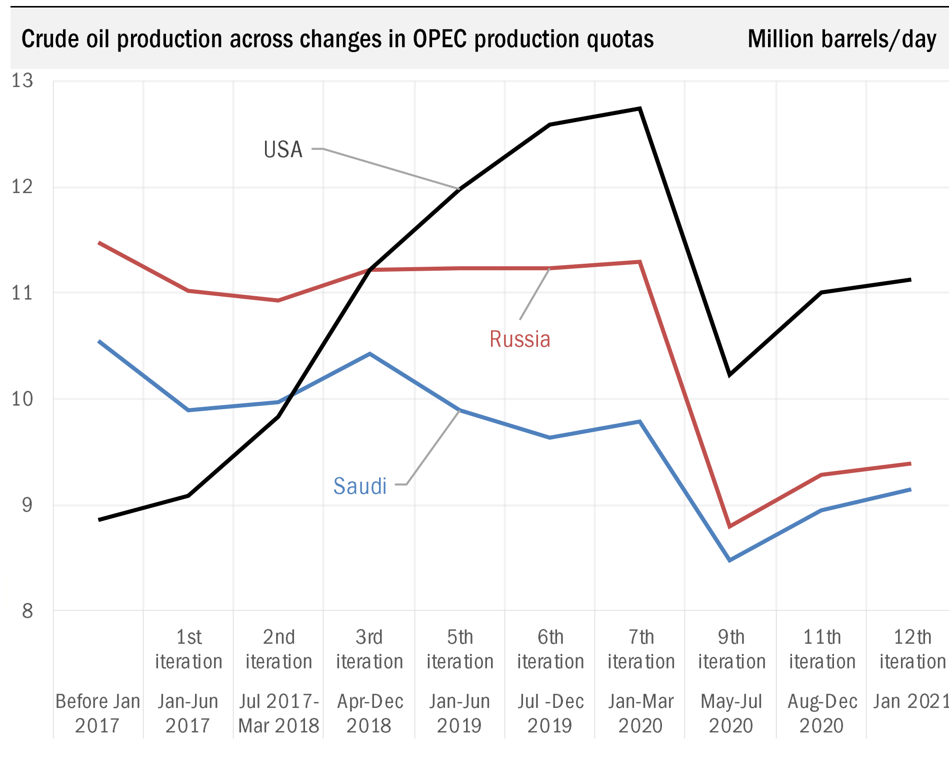
The beleaguered US energy sector has had quite a run, with stock prices up 48% since the late October lows, as the prospect of vaccines ignites optimism about completing a V-shaped economic recovery (see "Video: What you're not hearing about the third wave of Covid-19 and the V-shaped recovery" December 3, 2020). A global third wave of Covid-19 cases and some retrograde steps toward lockdowns have cast doubt on that recovery, but we think it's intact (see "On the November Jobs Report: Payrolls vs the Third Wave" December 4, 2020). The US oil industry has come through amazingly well. Beset by endless media doom-saying – as it has always been – *it remains an underloved cyclical opportunity as V-shaped economic recovery becomes complete and evolves into a new expansion, restoring the mobility that underlies demand for transportation fuel* (see "If It's a V-Shaped Recovery, What About Oil Prices?" September 24, 2020). Beyond recovery itself, there are two key underlying dynamics.

Update to strategic view

OIL, US RESOURCE STOCKS: US energy sector equities have rallied almost 50% over the last month as prices have improved and storage has burnt off from the highs. OPEC cuts accommodate the US as the world's number one oil producer. Restarting of shut-in wells seems to restore them to prior production levels with no reservoir damage, preserving ultimate expected recovery. Not requiring CAPEX to refrack, they are a form of low-cost below-ground storage and a source of ready free cash flow to meet financing needs in a bond market with still-wide spreads in the energy sector. The biggest uncertainty facing US oil producers is Biden's potential lifting of Iran sanctions, bringing 2 million barrels per day of new oil to the market.

[Strategy dashboard]

Crude oil production across changes in OPEC production quotas — Million barrels/day



Source: OPEC, EIA, TrendMacro calculations

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- *First, OPEC must continue to accommodate US production*. The doom-and-gloom media stories about US frackers never mention that the US became the world's top oil producing nation in 2018 and has remained so through the Covid-19 crisis and the recovery.
- The cartel has learned from bitter self-destructive experience that it must accept this reality. It learned it first in the 2015-2016 production war, and again this year in the brief pandemic-crisis price war (see "Just What We Didn't Need: An Oil Price War" March 8, 2020). Both episodes started as production free-for-alls, and ended up with quotas designed to liquidate excessive inventories and recover from too-low prices – as low as negative $40 in the most recent episode (see "On the WTI Crash" April 20, 2020).
- The most recent, and twelfth, iteration of production quotas came at last week's OPEC+ ministerial meeting (please see the chart on the previous page). *Continued compromise between Saudi and Russia led to new production cuts of 7.2 million barrels per day*, backing off from the 7.7 in place from August to December 2020. Monthly meetings will be needed to assess market conditions and decide on future production adjustments, Future adjustments will not be more than 0.5 million barrels per day. *These less stringent cuts matter – from August, global crude demand has come back much more than the adjustments, by something like 1.75 million barrels per day*.
- From the US perspective, these cuts fully make room for the resurgence of US production, which exceeded the resurgences of either Saudi Arabia or Russia (again, please see the chart on the previous page).
- *Second, cash-strapped highly-levered frackers must find the free cash flow – despite both lower production levels and lower prices – to keep themselves financed with spreads-to-Treasuries in the high yield market still wide*.
- So it is especially good news that the industry continues to experiment successfully with restarting fracked wells that had been shut-in during the demand collapse this spring (we first reported this in "If It's a V-Shaped Recovery, What About Oil Prices?"). Thousands of wells have been shut in, with the most shut-ins in regions with the highest costs (about a third of North Dakota's wells were shut in).
- The risk was, first, that restarted wells would have to be refracked – a very capital-intensive undertaking for a sector for whom capital is excessively costly right now. Second, some experts had predicted that restarted wells wouldn't recover their production profiles and would lose a big part of their estimated ultimate recovery (EUR).
- Several producers who have begun restarting wells are reporting that they are pleasantly surprised. Volumes are exceeding levels before the wells were shut-in, and apparently without damaging their EURs.
- EOG Resources provided some specific examples in the Permian Basin (please see their chart on the following page). Other company reports suggest, as a whole, that industry curtailments that peaked in May 2020 nearly recovered all of their production

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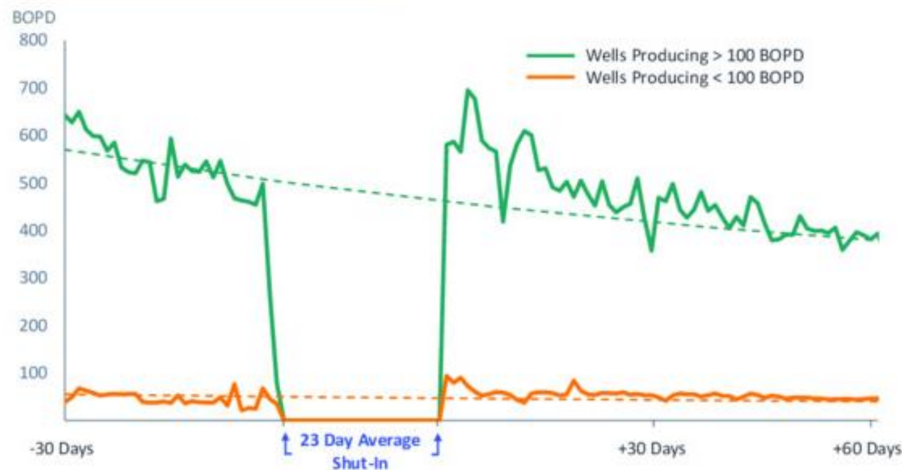
Production decline curves before and after well shut-ins

Tight Reservoirs Undamaged by Production Shut-Ins

Example of Shut-in Delaware Basin Wolfcamp and Bone Spring Wells



Source: EOG Resources, TrendMacro calculations

profiles by September. Others report that there was no reservoir damage caused by the shale shut-ins.

- Coupled with a vast inventory of drilled uncompleted wells (DUCs), shale operators now have a new modality to create optionality and lower storage costs by keeping oil in the ground. *Tactically, this oil is a ready source of free cash flow. Strategically, when above-ground storage clears as demand and prices improve, shut-in shale wells will be turned online again, a ready source of incremental volumes at a fraction of the cost of completing DUCs*.

Despite gaining in global market share and keeping the US the number one oil producer (again, please see the chart on the first page), there is no doubt that US shale producers have had a bad year.

- There have been 42 bankruptcies so far, with $53.8 billion lost across both oil and gas producers. But in 2016, there were 70 bankruptcies, with $56.8 billion lost. Shale was able to recover after the 2016 debacle and will do so again after 2020.
- To be sure the road ahead will still be bumpy. Libya production continues to surge after the permeant UN-backed ceasefire was announced, reportedly hitting nearly 1.25 million barrels per day by the end of November.
- The other big challenge is Iran. Jake Sullivan, a designated national security advisor of President-elect Joseph R. Biden said yesterday that he would like to resurrect the Iranian nuclear deal. Struck under the Obama presidency (see "How Will Biden Govern?" November 20, 2020), it reversed more than 35 years of US foreign policy in the region, and allowed Iran to become a major global oil exporter again.

- While the sanctions relief negotiations will be difficult – both with a presumably GOP-controlled US Senate and with Iranian hardliners – if Biden is successful, a new 2 million barrels per day of oil could enter the oil market. Right now, we are not making the call that it will happen quickly or at all. But the risk of reversing sanctions would have a deleterious effect on global oil markets and pricing and is probably the biggest risk faced by the US oil sector.

Bottom line

US energy sector equities have rallied almost 50% over the last month as prices have improved and storage has burnt off from the highs. OPEC cuts accommodate the US as the world's number one oil producer. Restarting of shut-in wells seems to restore them to prior production levels with no reservoir damage, preserving ultimate expected recovery. Not requiring CAPEX to refrack, they are a form of low-cost below-ground storage and a source of ready free cash flow to meet financing needs in a bond market with still-wide spreads in the energy sector. The biggest uncertainty facing US oil producers is Biden's potential lifting of Iran sanctions, bringing 2 million barrels per day of new oil to the market.